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Taking aim at your taxes 1996: A CPA's guide for small businesses

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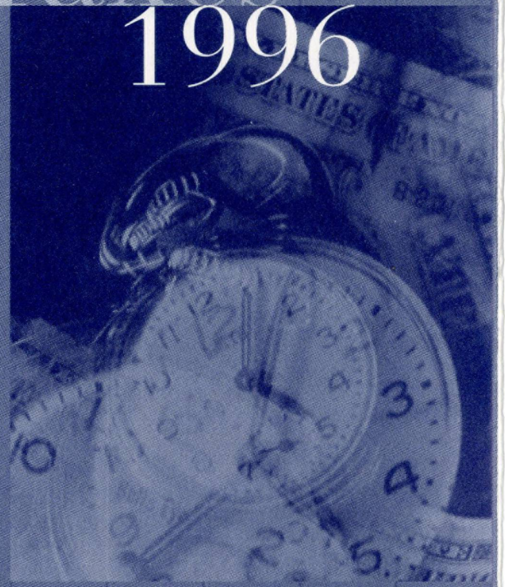
Taking Aim At Your Taxes 1996



A CPA's Guide For Small Businesses

Doing business in the '90s is a whole new ball game – tough competition, a global playing field and no easy outs. As a business owner, you know all too well the new challenges and uncertainties that face you at every turn. But there is one certainty you can control – that is, your tax bill for the year. All it takes is a little planning and the knowledge to steer clear of some common pitfalls. To help you gear up, this brochure provides practical tax information as well as some tax-saving tips.

The Basics

Your business' basic tax bill varies depending on whether its income is taxed at the individual or corporate rate. Individual rates begin at 15 percent, but may reach 39.6 percent. Corporate rates are as follows:

Taxable Income Over	Not Over	Tax Rate
$ 0	$ 50,000	15%
50,000	75,000	25
75,000	100,000	34
100,000	335,000	39
335,000	10,000,000	34
10,000,000	15,000,000	35
15,000,000	18,333,333	38
18,333,333		35

Choosing Your Tax Identity

Because of the wide variation in individual and corporate tax rates, CPAs recommend that you give very careful consideration to your business' organization. In effect, you can elect your tax treatment by choosing among several organizational options. The basic categories, available in most states, are sole proprietorship, partnership, corporation and limited liability company, or LLC.

Sole Proprietorships and Partnerships. In a sole proprietorship or partnership, business income and losses are "passed through" to the individual owners and are taxed at individual rates.

C Corporations. A "C Corporation" is the most standard form of corporation, with business income taxed at corporate rates. Under federal and state tax laws, regular C Corporations and their owners are treated as separate taxable entities. When earnings are distributed as dividends, they are taxable to the shareholders at individual rates. For this reason, income from a C Corporation is said to be subject to "double" tax.

S Corporations. An "S Corporation" is a special type of elected status in which your business' income and expenses are passed through to shareholders and taxed at their individual rates, whether or not the income is actually distributed. S Corporations are generally not subject to corporate income tax, and distributions usually are not taxable to shareholders. So, income is taxed only once. Keep in mind, though, that S Corporation status carries special eligibility requirements.

Limited Liability Companies (LLCs). Generally, LLCs combine the "limited liability" feature of a corporation with the tax treatment of a partnership – that is, the LLC's income is taxable to the LLC members at their individual rates, and separate corporate tax is assessed on the LLC. In most cases, members are not liable for debts and obligations of the business.

Personal Service Corporations (PSCs). PSCs are employee-owned corporations that provide services in such areas as health, law, engineering, architecture, accounting and consulting. PSCs operating as C Corporations pay a flat tax rate of 35 percent, regardless of the level of income. You also can elect to have the PSC taxed as an S Corporation, or convert it to an LLC, to change its tax treatment – but check first with your CPA.

Tax-Trimming Tips for the Small Business

Tax Deductions for Compensation for Services. Where corporate tax rates exceed individual tax rates, you can reduce overall taxes by compensating yourself and members of your family for services provided to the corporation. In order to deduct this compensation, however, the amount must be reasonable in relation to the services provided. If the IRS determines that the compensation is excessive, it may disallow the compensation deduction and treat unreasonable payments as nondeductible dividends to the owner. In addition, you also must consider the effect of employment taxes assessed on such wages.

Employment-Tax Reduction. Since income distributions to an S Corporation shareholder are not subject to employment taxes, you can pay yourself a reasonable salary and withdraw the excess from the company free of such taxes.

Employee vs. Independent Contractor Status. You may be able to save on employment taxes (as well as fringe benefits) by classifying certain workers as independent contractors, rather than as employees. However, be sure you know the special rules for qualifying as an independent contractor as opposed to an employee. You will face stiff penalties for misclassifying an employee as an independent contractor.

Retirement Plan Contributions. CPAs recommend that you take advantage of tax benefits associated with IRS-qualified retirement plans for your employees. As the employer, you can take current tax deductions for contributions to IRS-qualified retirement plans for your employees, and your employees will not recognize taxable income until they withdraw the funds from the plans.

Deferred Compensation Plans. The use of qualified and non-qualified deferred compensation plans also can provide valuable tax benefits both to you and your employees. Deferred compensation plans allow employees to elect to postpone receipt of part of their current salary until later years. Therefore, if you or your key employees currently are in a high tax bracket, you may want to consider establishing a deferred compensation plan to defer income from high-income years to low-income (such as retirement) years.

Flexible Spending Accounts. Flexible spending accounts provide you and your employees tax savings because the contributions are not subject to federal income or employment taxes. Contributions also may be free from state and local income tax.

Business Property Depreciation. Generally, businesses can elect to deduct immediately up to $17,500 of the cost of qualifying property in the year it is placed into service. However, keep in mind that this "immediate expensing" deduction is limited to certain depreciable property used in the business (such as office equipment or machinery) and begins to be reduced dollar for dollar once the cost of the property exceeds $200,000.

Travel, Meal and Entertainment Expenses. If your business routinely reimburses employees for travel, meal and entertainment costs, make sure you meet the accountable reimbursement plan rules to ensure that such reimbursements will be deductible by your business and that they will not be treated as taxable income to the employee. Business travel expenses are fully deductible, and business-related meals and entertainment 50-percent deductible. The rules mandate that the employee submit adequate supporting documentation. In addition, you may elect to pay your employees a "per diem" allowance, in lieu of reimbursing actual travel and meal expenses, as long as the amount does not exceed the applicable federal per diem rate – which varies depending on geographic location.

Charitable Contributions. As a business owner, you should evaluate whether you obtain a greater tax benefit by making charitable contributions through your business or from your personal funds. Once again, this determination varies depending upon the applicable tax rates for you and your company.

Family Employment. You may be able to reduce your business' overall taxes by paying members of your family for services provided to the corporation. If you hire your parents, spouse or child under age 21, the business can deduct the salaries and, if the business is unincorporated, does not have to pay Federal Unemployment (FUTA) tax for the family member. If your child is under age 18 and works for you, Social Security (FICA) tax does not have to be paid either.

Obsolete Inventory Deductions. Review the rules for deducting obsolete inventory. Goods that cannot be sold at normal prices or in the usual way because of damage or changes of style may be valued for deduction purposes at bona fide selling prices, less direct costs of disposition. Take necessary steps, such as disposing of obsolete inventory, to realize expected losses.

Bad Debt Write-Offs. If your business uses the accrual method of accounting, review all outstanding business debts to determine which are uncollectible. If you have outstanding receivables with no chance of collection, write them off in the year they become partially or totally worthless.

Deductions for Health Insurance Premiums and Self-Employment Taxes. Self-employed persons, partners in partnerships and S Corporation shareholders may deduct from gross income up to 30 percent of premiums paid for health insurance for themselves, spouses and dependents. Sole proprietors and partners also may deduct up to 50 percent of self-employment taxes assessed on their net earned income.

The Most Advantageous Accounting Method. One aspect of tax planning you should not overlook is choosing the right accounting method. Generally, taxpayers may choose between the cash and accrual methods of accounting for reporting income and deductions. All taxpayers generally are required to use the accrual method if inventory items are "material income producing factors." Therefore, you should seek the advice of your CPA to determine which method is best (or required) for your business and, if you currently are using an impermissible one, how to reduce the tax cost of changing methods.

Acceleration of Deductions and Deferral of Income. If you use the cash method of accounting, you may be able to defer recognizing income and prepay some expenses to reduce your current year's tax bill. If you are an accrual-basis taxpayer, however, you generally must report income in the year when the right to the income is secured, whether or not it has actually been received. Likewise, as an accrual-basis taxpayer, you generally will not be able to prepay your expenses. Regardless of what method you use, your CPA can help you make the most of the opportunities that are available.

Estimated Tax Payments. If you anticipate that your business will owe $500 or more in income taxes for the year, you must pay your estimated tax bill in quarterly installments. Corporate taxpayers with annual taxable incomes of $1 million or less may avoid stiff underpayment penalties by making quarterly estimated tax payments of at least 100 percent of the prior year's tax (provided there was tax owed, and it was a full tax year). However, if your company's taxable income was at least $1 million in any of the last three tax years and you made estimated tax payments that totaled less than your actual current year's taxes, you cannot avoid the underpayment penalty.

Penalty Avoidance. Making a mistake in calculating your taxes can be quite costly. The IRS may assess a 20-percent penalty on negligent underpayment, in addition to any taxes that are owed, if you fail to follow the tax rules.

Financial Advice. Even for the smallest of businesses, tax rules can be complex and compliance difficult. CPAs – as highly qualified business and financial advisers – can provide the expertise you need to minimize your taxes and maximize your profits.